

**A comparative analysis of the projects undertaken in the
development of a taxation framework in the digital economy**

By

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List of Abbreviations

Abbreviation	Meaning
Act/ITA	Income Tax Act, 58 of 1962
Action Plan	OECD Action Plan on Base Erosion and Profit Shifting
App	Application
BEPS	Base Erosion and Profit Shifting
B2B	Business to Business
B2C	Business to Consumer
C2C	Consumer to Consumer
CFC	Controlled Foreign Company
CGT	Capital Gains Tax
Commissioner	The Commissioner of the South African Revenue Service
Digital Economy Report	OECD / G20 BEPS Project Addressing the tax challenges of the digital economy Action: 2015 Final Report
DTA	Double Taxation Agreement
DTC	Davis Tax Committee
e-commerce	Electronic Commerce
European Commisson	European Commission Expert Group on Taxation of the Digital Economy
European Commission Report	Report of the European Commission Expert Group on Taxation of the Digital Economy, 28 May 2014
ICT	Information and Communication Technology
MNE	Multinational Enterprise
MTC	Model Tax Convention
OECD	Organisation for Economic Cooperation and Development
OECD MTC	OECD Model Tax Convention on Income and on Capital, 2014

OECD Commentary	Commentary of the OECD on the OECD MTC
PE	Permanent establishment
SARS	The South African Revenue Service
TAA	Tax Administration Act, 28 of 2011
TAG	Technical Advisory Group
TFDE	Task Force on the Digital Economy
VAT	Value Added Tax

1. Introduction

1.1. Background

Over the last decade, the world economy has become increasingly digital. This digitalisation of products and services has grown to such an extent that there now exists a “digital economy”. Through the digitisation of products and services, the digital economy has broken down geographical barriers and brought businesses and customers closer together. Businesses operating in the digital economy are highly mobile and require little or no physical presence which, in light of the existing traditional tax principles, creates certain tax planning opportunities for enterprises in the digital economy.¹

Nearly two decades ago, e-commerce started drawing attention as a rapidly growing force in the economy. The Organisation for Economic Co-operation and Development (“OECD”) initiated an international inquiry into the tax treatment of e-commerce and after 6 years, the OECD’s Technical Advisory Group (“TAG”)² concluded that “existing concepts seem sufficient to ensure tax-neutral treatment for e-commerce and physical transactions”.³ 15 years after the initial inquest of the TAG, the OECD has once again been called to consider the tax implications of e-commerce. However, commerce via electronic platforms have grown to such an extent over the last decade, that the OECD now has to consider the tax implications of an entire “digital economy”, of which e-commerce is a faction.

Political leaders, media houses and, to some extent, the public at large, have expressed a concern about tax planning by multinational enterprises (“MNEs”) that make use of tax planning opportunities to reduce their taxable income or shift profits to tax favourable jurisdictions, where there is often little or no economic activities performed by that MNE, in ways that erode the taxable base.⁴ These tax planning activities conducted by MNEs have given rise to a

¹ European Commission *Report of the Commission Expert Group on Taxation of the Digital Economy* (“European Commission Report”) at 5.

² OECD *Report by the Technology Technical Advisory Group*

³ OECD / G20 BEPS Project *Addressing the tax challenges of the digital economy Action: 2015 Final Report* (“*Digital Economy Report*”) at 20.

⁴ OECD Digital Economy Report, *op cit* note 3 at 16.

concept popularised as “base erosion and profit shifting” (“BEPS”).⁵ The key features of, and new business models in, the digital economy have given rise to opportunities for BEPS.⁶

In an attempt to address tax planning activities which lead to BEPS, the OECD, at the request of the G20, published an “Action Plan on Base Erosion and Profit Shifting” in July 2013⁷ (“BEPS Action Plan”), which report identifies 15 actions⁸ to address BEPS in a seemingly comprehensive manner.⁹ Addressing the tax challenges of the digital economy is the first of these 15 action points.

After the release of the BEPS Action Plan, the OECD established a Task Force on the Digital Economy (“TFDE”) which was tasked with facilitating public discussion forums and drafting a report on the taxation of the digital economy.¹⁰ The TFDE subsequently released public discussion drafts on some of the BEPS action points. Among these discussion drafts was the “Public Discussion Draft BEPS Action 1: Address the tax challenges of the digital economy, released on 14 March 2014.¹¹ Subsequently the OECD received public comment from lobbyists, corporates, NGO's. advisors and individuals, after which the TFDE incorporated the public comments received

⁵ Refer the OECD 2013 report titled *Addressing Base Erosion and Profit Shifting*.

⁶ OECD Digital Economy Report, *op cit* note 3 at 16.

⁷ OECD (2013) *Action Plan on Base Erosion and Profit Shifting*.

⁸ The 15 Action points identified by the OECD's BEPS Action Plan includes:
 Action 1: Addressing the Tax Challenges of the Digital Economy;
 Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements;
 Action 3: Designing Effective Controlled Foreign Company Rules;
 Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments;
 Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance;
 Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances;
 Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status;
 Actions 8-10: Aligning Transfer Pricing Outcomes with Value Creation;
 Action 11: Measuring and Monitoring BEPS;
 Action 12: Mandatory Disclosure Rules;
 Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting;
 Action 14: Making Dispute Resolution Mechanisms More Effective; and
 Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties.

⁹ OECD Digital Economy Report, *op cit* note 3 at 16.

¹⁰ OECD Digital Economy Report, *op cit* note 3 at 14.

¹¹ OECD *Public Discussion Draft BEPS Action 1: Address the tax challenges of the Digital Economy*.

before the OECD released its final report titled “Addressing the tax challenges of the Digital Economy Action 1: 2015 Final Report”.

In parallel to the work conducted by the OECD, locally, the Davis Tax Committee (“DTC”) set up a sub-committee which was tasked with investigating the taxation of the digital economy within the South African context.¹²

The digital economy is generally characterised by a deep reliance on intangibles, the extensive use of data and the widespread adoption of multi sided business models capturing value from externalities generated by free products.¹³

One of the problems which tax authorities and tax advisors are faced with is the fact that it is extremely difficult to determine the jurisdiction in which value is created within the digital economy. This difficulty raises fundamental questions with regard to how enterprises in the digital economy add value and generate profits, and how the digital economy fits into the traditional tax concepts of source, residence, PE, or the characterisation of income for tax purposes.¹⁴

The OECD Digital Economy Report states that it is important to examine how MNEs operating within the digital economy add value and generate profits in order to determine whether and to what extent it may be necessary to address possible changes to the existing international taxation framework and thereby take into account the specific features of the industry in order to address challenges presented by the digital economy in relation to BEPS.¹⁵

1.2. Objectives

The objective of this comparative paper is to analyse and compare the work undertaken by the OECD’s TFDE and the DTC on the taxation of the digital economy in light of the overarching project on BEPS, with a view of analysing the possible application of the proposed options to

¹² Ministry of Finance (2014) *Media Statement Davis Tax Committee call for submissions at <http://www.taxcom.org.za/docs/3%20June%202014%20%20The%20Davis%20Tax%20Committee%20calls%20for%20submissions.pdf>* [accessed 17 September 2015].

¹³ OECD Digital Economy Report, *op cit* note 3 at 16.

¹⁴ *Ibid.*

¹⁵ *Ibid.*

address the tax challenges of the digital economy in the South African taxation framework.

1.3. Limitations

For purposes of this paper, only direct taxes will be analysed. Indirect taxes, including Value-Added Tax, are therefore outside the scope of this paper.

2. The digital economy

2.1. Introduction

Through various advances in the field of Information and Communication Technology ("ICT"), the digital economy has developed to such an extent that it is impacting on all sectors of the economy and society which includes retail, transport, financial services, manufacturing, education, healthcare and media.¹⁶

Defining what constitutes the digital economy has proven problematic, because of the ever-changing technologies of the ICT sector and the widespread diffusion of the digital economy within the whole economy. The digital economy is best described at the hand of a number of its key features, which include mobility, the high use of use data, and multisided business models.¹⁷

The digital economy is mobile, with little geographic limitations. Product and service offerings have increased in mobility, since the cost of storing and transporting digital products have reduced to virtually zero. Companies are therefore able to operate virtually anywhere across the globe, often with no physical bricks and mortar presence within the markets it operates and generates profits, often resulting in no taxable presence in these countries.

The digital economy has had a significant impact on many world economies, with Booz & Company's econometric analysis estimating that, even in a "bear market" economy, digitisation created a 193 billion USD boost to world economic output and created 6 million jobs globally in 2011.¹⁸ On the macro side, Van Ark et al. (2014)¹⁹ calculated that 64% of the growth in labour productivity in the US

¹⁶ European Commission Report, *op cit* note 1 at 11.

¹⁷ *Ibid.*

¹⁸ *Digitization for Economic Growth and Job Creation: Regional and Industry Perspectives*, Booz & Company (online) (http://static.wamda.com/web/uploads/resources/BoozCo_Digitization-for-Economic-Growth-and-Job-Creation.pdf) [accessed 20 October 2015]

¹⁹ Van Ark B., van Welsum D. and Overmeer W. (2014) (Online) "Unlocking the ICT growth potential in Europe: Enabling people and businesses - Using Scenarios to Build a New Narrative for the Role of ICT in Growth in Europe" [accessed 20 October 2015]

between 1995-2007 was led by ICT (and complementary) investments.

The economy at large, across all sectors, have increasingly adopted and implemented ICT in an attempt to enhance productivity, enlarge market reach, and reduce operational costs. These technologies have also changed the ways in which such products and services are produced and delivered, as well as the business models used in companies ranging from multinational enterprises (MNEs) to start-ups.²⁰

With the development of the digital economy, businesses operating within the digital economy are now able to leverage global value chains from anywhere in the world, no longer being bound to a specific geographic market.

In the initial phases of the development of the digital economy, businesses applied the principles of the traditional economy, a bricks and mortar business model, to the digital economy, by selling physical goods and services online. Over time, the digital economy continued to progress and develop, moving from traditional business models to the emergence of new business models, increasingly blurring the line between goods and services.²¹

2.2. Key features of the digital economy

Certain prominent features which increasingly characterises the digital economy are relevant when considered from a tax perspective. These key features include:²²

Mobility

The mobility of intangibles, users and business functions. This is a result of the ever decreasing need for a physical presence with local personnel as well as the flexibility to choose the location of the required resources, such as servers. Due to the mobility of the digital economy it is difficult to determine where value is added and where

²⁰ OECD Digital Economy Report, *op cit* note 3 at 52.

²¹ OECD Digital Economy Report, *op cit* note 3 at 53.

²² OECD Digital Economy Report, *op cit* note 3 at 64.

the source of the income is situated. Included with mobility is also the flexibility in many cases to choose the location of the company servers and business resources.²³

A reliance on data.

The digital economy relies heavily on data, and the use of personal data of individuals which can be utilised for advertising purposes, or to target service offerings. This data is often vital for businesses conducting targeted marketing and services offerings custom designed for specific jurisdictions and may be valuable in the value chain of certain MNEs. Many tax authorities have been challenged with the question of whether there should be a value attached to data, and then how to actually value such data.

Multi-sided business models

In a multi-sided business model, multiple groups of persons interact through an intermediary or platform and the decisions of each group affects the other groups. For example, an operating system is more valuable to end users if more developers write software for it, and more valuable to software developers if more potential software purchasers use the operating system. Accordingly, the value of profits of an enterprise is often dependant on or attributable to the value of another enterprise.²⁴

Monopoly or oligopoly

A few players may have a dominant position in a short time in an immature market, due to the network effects combined with low incremental costs. This dominant position may be enhanced where a patent or IP grants one business the exclusive power to exploit a specific invention.

Volatility

The digital economy has low barriers to entry, with internet available without large start-up costs, the market has miniaturised, leading to

²³ OECD Digital Economy Report, *op cit* note 3 at 65.

²⁴ OECD Digital Economy Report, *op cit* note 3 at 71.

high volatility. One business may be dominant for a short time, before another business puts forward a better value proposal or a more sustainable business model, with few companies managing to secure long term success.²⁵

2.3. New business models in the digital economy

The advances in ICT have given rise the emergence of various new business models. Although these new business models are often based on traditional business models, the advances in ICT enable businesses, large and small to conduct business anywhere in the world, from virtually anywhere in the world. The OECD's Digital Economy Report examines some of the new business models:

Electronic Commerce("e-commerce")

E-commerce has been defined broadly as:²⁶

"the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The goods or services are ordered in those methods, but the payment and the ultimate delivery of the goods or service do not have to be conducted online. An e-commerce transaction can be between enterprises, households, individuals, governments, and other public or private organisations"

e-commerce therefore includes the purchasing of goods and services online that are then delivered through traditional means, and e-commerce also includes the purchasing of goods or services completely electronically.²⁷

The most prominent business models within the e-commerce realm are Business-to-Business models ("B2B"), Business-to-Consumer models ("B2C"), and Consumer-to-Consumer models ("C2C").

Payment services

Through advancements in ICT, users making online payments are no longer required to provide bank account or credit card information to

²⁵ OECD Digital Economy Report, *op cit* note 3 at 73.

²⁶ OECD (2011) *OECD Guide to Measuring the Information Society 2011*, OECD Publishing, Paris.

²⁷ OECD Digital Economy Report, *op cit* note 3 at 55.

each vendor or individual in order to effect payments. Online payment service providers have created a secure way to enable users to make secure online payments without requiring the parties to the transaction to exchange or share their financial information with each other.

In terms of this business model, the payment service provider usually acts as the intermediary, utilising a “software-as-a-service” model, between the parties to the transaction.²⁸

The online payment solutions includes cash payment solutions, e-wallets and mobile payment solutions and virtual currencies.

Application Stores (“app-stores”)

The rise of the digital economy can, in part, also be ascribed to availability of access to the internet through smartphones and tablets, which has caused an increase in the frequency of use of online services and the development of app stores.²⁹

App stores constitute a digital distribution platform for software. These app stores are generally in the form of central retail platforms accessible through smartphones and tablets, through which the user is able to browse and make purchases, download and install the applications on their device.³⁰

The content available on app stores may either be developed by the business operating the app store, the business manufacturing the device or by a third party.

The business model of an app store includes free applications (“apps”), apps at a fee, or “freemium” apps in which basic functionality is provided for free but customers may pay for additional content and features. These apps may be further supported and funded by in-app advertising.

²⁸ OECD Digital Economy Report, *op cit* note 3 at 57.

²⁹ OECD Digital Economy Report, *op cit* note 3 at 58.

³⁰ OECD Digital Economy Report, *op cit* note 3 at 58.

App stores are generally aimed at specific geographic markets, whilst the apps available on the app store are designed with a global market in mind. The apps may be cross listed on various app stores.³¹

Online advertising

The use of online advertising offers many advantages over the use of traditional marketing. The advantages of using online advertising continually increase as it is often more effective than traditional advertising. Many advertisers access large user bases with sophisticated algorithms to collect, analyse, and process user data in order to create targeted advertisements.³²

Online advertising takes various forms, including display ads, search engine ads and content ads. The players in the online advertising value chain includes web publishers, advertisers and advertising intermediaries. The advertising intermediaries connect web publishers and advertisers and include search engines, media companies and technology vendors.³³

In the advertising-based business models, web publishers of content are often willing to provide free or subsidised services to clients in order to establish a large consumer audience and thereby attract advertisers to the online platform of the publisher.³⁴

In traditional advertising, the cost of the advertisement is often based on the prominence and time of the ad displayed, with little way of monitoring the user response to the ad. Online advertising has however introduced a number of new business and price models which includes the cost per mile model, in terms of which advertisers pay per display of the add to the consumer; the cost per click model in terms of which advertisers only pay when users click on the ad; and the cost per action model in terms of which advertisers pay only when a specific action is completed by a consumer.³⁵

³¹ OECD Digital Economy Report, *op cit* note 3 at 58.

³² *Ibid.*

³³ OECD Digital Economy Report, *op cit* note 3 at 59.

³⁴ *Ibid.*

³⁵ *Ibid.*

Cloud Computing

Cloud computing is the provision of on-demand online computer services which includes computing, data management, storage, and software using shared physical and virtual resources, such as networks, servers and apps.³⁶

The resources to which cloud computing users have access are not stored a single device, but on many networked computers that are available to all cloud computing customers. It provides customers with cost effective alternative to maintaining its own IT infrastructure as cloud computing is largely driven by economies of scale in setting up the infrastructure and maximising server usage by sharing space between customers.³⁷

2.4. Diversity of Revenue models

The manner in which businesses turn value into revenue highlights the diversity of the business models in the current digital economy. The most common revenue models include the following:³⁸

- Advertising based revenues - Free or discounted content is provided to users, with advertisements imbedded in the content.
- Digital content purchases or rentals – Users pay per download of the content, which includes e-books, music, apps, and videos.
- Selling of goods – Businesses offer physical or virtual goods for sale on an online platform.
- Subscription-based revenues – Users can subscribe for digital content such as music, software and news at a weekly or monthly subscription premium.
- Selling of services – Users can purchase services on an online platform. The services may include traditional services such as

³⁶ OECD Digital Economy Report, *op cit* note 3 at 60.

³⁷ *Ibid.*

³⁸ OECD Digital Economy Report, *op cit* note 3 at 64.

legal or financial services or digital services such as internet access services and web hosting services.

- Licensing content and technology – Users can license or purchase online content such as software, cloud based operating systems and algorithms.
- Selling of user data and customised market research
- ‘Hidden’ fees and loss leaders – Integrated businesses may attribute profits or losses to online operations, but because of the high level of business integration, cross-subsidy with other operations occur and it is difficult to identify the online revenue. This would include “free” online banking, which is subsidised through other banking operations and fees.

2.5. Conclusion

Due to the development of ICT and the rise of new business models within the digital economy, the traditional “bricks and mortar” business models have become less important. With new technologies, business can operate from virtually anywhere in the world and are no longer restricted to customers in their immediate geographic location. Business no longer require a physical presence to operate within a country and can provide goods and services to customers around the world.

As goods and services within the digital economy such as payment services, app stores, e-commerce, online advertising and cloud computing utilises new business models, the existing taxation framework might not adequately address these business models. By applying the traditional principles of source and permanent establishments (“PE”), businesses might well not be taxed where the economic value is created or where the profits are derived.

The current taxation framework is considered below, with reference to the business models an key features identified above.

3. The current taxation framework

3.1. Introduction

Various interest groups have recently suggested that the increasing relevance and increasing number of transactions occurring within the digital economy require a re-evaluation of many traditional tax laws and principles. In 2002 it was argued that due to the increase in the internet related economy activity, holding onto traditional principles of taxation will in the long run lead to adverse outcomes for governments, including revenue losses resulting from the inability to effectively collect taxes on digital economic activities.³⁹

In order to establish whether the developments of ICT and the digital economy require an re-evaluation or overhaul of the existing taxation framework and policy, the existing tax laws and principles are considered below.

3.2. Ottawa principles of tax policy

Raising revenue remains one of the most important functions of taxes, which taxes serve as the primary means for a government to finance public services and public infrastructure. The revenue raised by a State will depend largely on the fiscal policies of that State. In establishing fiscal policy, a number of tax policy considerations have been articulated. The tax policy principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness as well as flexibility laid the foundation for the 1998 Ottawa Ministerial Conference and have since then been referred to as the Ottawa Taxation Framework Conditions.⁴⁰

³⁹ Cockfield, AJ *The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles* at 606.

⁴⁰ OECD Digital Economy Report, *op cit* note 3 at 20.

The Ottawa Taxation Framework principles provide for the following conditions:

- Neutrality – Taxation must be neutral and equitable for all forms of commerce, whether traditional or electronic. Taxpayers in similar circumstances carrying on similar transactions should be subject to similar levels of taxation.
- Efficiency – Compliance costs for taxpayers and administrative costs for tax authorities should not be disproportional to the income received.

The OECD is of the opinion that the Ottawa Taxation Framework is still relevant for the digital economy and should be utilised when considering whether an overhaul of the current taxation framework is required.⁴¹

3.3. Taxation of cross border income

When cross-border investments take place, or where funds flow between States or even where taxpayers of different States enter into economic transactions, the interaction of the tax laws of the respective States concerned will determine the fiscal implications for the parties involved.⁴²

Taxation on income is fundamentally territorial. Every State has the sovereign power to establish a tax base to enforce and collect taxes within its sovereign jurisdiction. Countries therefore constantly endeavour to increase the collection of revenues by extending the jurisdiction on which it imposes taxes, even extending its tax base beyond its geographical borders, however practical difficulties may arise in collecting taxes from beyond its own geographical borders.⁴³

International tax laws sets no formal limitation on the extent of a State's jurisdictional powers to levy tax in terms of its own legal and fiscal framework. However, in terms of customary international law, the fiscal jurisdiction of a State is generally limited by requiring a fiscal attachment between the State and the taxpayer. Traditionally, the *nexus* which establishes fiscal jurisdiction is referred to as residence taxation or source taxation.⁴⁴

-
- Certainty and simplicity – Tax legislation should be simple and clear to understand so taxpayers can anticipate the tax consequences of transactions, which includes calculating a tax liability.
 - Effectiveness and fairness – Tax rules should produce the right amount of tax at the right time, curbing tax avoidance in proportion to the costs to counteract those avoidance strategies.
 - Flexibility – the systems for taxation must be flexible and adaptable to ensure that such systems keep pace with commercial and technological developments.

⁴¹ OECD Digital Economy Report, *op cit* note 3 at 20.

⁴² De Koker A in De Koker A *Silke on International Tax* at 1.1.

⁴³ De Koker, *Silke on International Tax*, *op cit* note 42 at 1.2.

⁴⁴ *Ibid.*

In the case of natural persons, residence taxation is based on a pre-dominant physical presence or ordinary residence within that jurisdiction. In the case of juristic persons the requisite *nexus* is the doctrine of economic or fiscal allegiance such as the factual basis of a company's place of incorporation or the location of the registered office, or the place where management and control, or place of effective management of the juristic person is located. In fact, the application of the PE or fixed place of business test is widely accepted as the nexus for residence based taxation for juristic persons.⁴⁵

It should be noted that the residence basis of taxation has also been extended in terms of the rule that a State is allowed to tax controlled foreign companies ("CFC"), that is foreign companies which are controlled by residents of that State just as if those foreign companies were themselves residents of that State.⁴⁶

In contra-distinction to the residence basis of taxation is the source basis for taxation. Source taxation occurs where a State imposes tax on income arising within its jurisdiction where that income has a sufficient economic nexus to that State. The source basis of taxation relies upon a connecting factor of which the referent is the income, not the person who earns it..⁴⁷

The taxation framework of most modern tax systems therefore taxes the worldwide assets and worldwide income of legal subjects who are resident, as defined in the domestic tax laws of that State, in its domestic territory. It also allows for the taxation of the property of non-residents that is situated in the territory of that State, including the income originating from such property.⁴⁸

In an attempt to regulate the taxes imposed by various States on a residence and source basis, model taxation conventions ("MTC") have been developed in order to assign taxing rights to States in instances where taxpayers may be subject to tax in two States, causing the

⁴⁵ De Koker *Silke on International Tax*, op cit note 42 at 1.2.

⁴⁶ *Ibid.*

⁴⁷ *Ibid.*

⁴⁸ *Ibid*

taxpayer to suffer double taxation. These MTCs provide a basis from which two States can conclude a double taxation treaty (“DTA”) which assigns taxing rights between States.⁴⁹

3.4. OECD Model Tax Convention

The aim of the OECD Model Tax Convention on Income and on Capital (2014) (“OECD MTC”) is to clarify, standardise, and confirm the fiscal situation of taxpayers who are engaged in commercial activities in more than one country, through the application by all countries of common solutions to identical cases of double taxation.⁵⁰

The OECD MTC aims to provide a means of settling, on a uniform basis, the most common problems which arise within the scope of international juridical double taxation.

The OECD MTC forms the basis for the negotiation of DTAs between two States. These DTAs are generally entered into in an attempt to avoid double taxation.⁵¹

The OECD MTC essentially divides taxing rights of States into three different classes, namely⁵²:

- a) income and capital that may be taxed without limitation in the Source State (e.g. profits attributable to a PE in the Source State);
- b) income that may be subjected to limited taxation in the Source State (e.g. dividends and interest); and
- c) income and capital that may not be taxed in the Source State (e.g. business profits not attributable to a PE).

Of specific relevance for the challenges which the digital economy poses to the current taxation framework is Article 5 and Article 7 of the OECD MTC.

⁴⁹ De Koker *Silke on International Tax*, op cit note 42 at 1.3.

⁵⁰ OECD (2014) *Model Tax Convention on Income and on Capital* (“OECD MTC”) at 7.

⁵¹ Olivier L and Honiball M *International Tax: A South African Perspective* (2011) (“Olivier International Tax”) at 276.

⁵² *Ibid.*

Article 5 – Permanent Establishment

Article 5 of the OECD MTC is of significance in the international taxation framework as the concept of a PE is largely relevant for the assignment of taxing rights in terms of a DTA. The significance of having a PE in a country is that it gives the country in which it is situated the right to tax the entity under its domestic laws, notwithstanding the fact that the PE has no separate legal existence.⁵³ Article 5 of the OECD MTC does not, in itself, create taxing rights, but only assigns taxing rights which exist under domestic laws.⁵⁴

Article 5 of the OECD MTC provides, *inter alia*, that:

- “1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.*
- 2. The term "permanent establishment" includes especially:*
 - a) a place of management;*
 - b) a branch;*
 - c) an office;*
 - d) a factory;*
 - e) a workshop, and*
 - f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.*
- 3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.*
- 4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:*
 - a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;*
 - b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;*
 - c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;*
 - d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;*
 - e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;*
 - f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business*

⁵³ Olivier *International Tax*, op cit note 51 at 335.

⁵⁴ *Ibid.*

resulting from this combination is of a preparatory or auxiliary character.”

Articles 5(5) and 5(6) provide for “agency” PEs, in terms of which an enterprise may have a PE in a Source State where a person acts on behalf of that enterprise in the Source State, habitually concluding contracts in the name of the enterprise.⁵⁵

As stated above, the main use of the PE concept is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. Under Article 7 of the OECD MTC, a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a PE situated therein.⁵⁶

In terms of paragraph 1 of Article 5, an enterprise will only have a PE if it has a “fixed place of business”. The current definition of a PE therefore focuses on traditional business models where enterprises either have a bricks and mortar office or other fixed place of business, or an agent in countries where that enterprise conducts business.

However, one of the key features of the digital economy is that it is highly mobile, able of being operated from any geographical area whilst serving customers in any geographical area. The digital economy is therefore not dependant on bricks and mortar buildings and offices. Participants in the digital economy are able to conduct a large scale, multi-million rand operation in a country, without having a single agent, office or other fixed place through which its business is conducted situated in that country. Accordingly, in terms of the current provisions of Article 5 of the OECD MTC, that person will not have a PE in the Source State.⁵⁷

Article 7 – Business Profits

Article 7 of the OECD MTC allocates taxing rights with respect to the business profits of an enterprise of a Contracting State where such

⁵⁵ OECD MTC Article 5.

⁵⁶ OECD, *Commentaries on the articles of the Model Tax Convention* at 94.

⁵⁷ European Commission Report, *op cit* note 1 at 48.

profits are not subject other more specific Articles under the OECD MTC.⁵⁸

Article 7 of the OECD MTC provides, *inter alia*, that:

“1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

2. For the purposes of this Article and Article [23A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise...

Accordingly, in terms of Article 7 of the OECD MTC, unless an enterprise of a Contracting State has a PE situated in the other Contracting State, the business profits of that enterprise may not be taxed in that other State.⁵⁹

As stated above, enterprises within the digital economy may quite often not have a PE in the other States in which it conducts business. Accordingly, the business profits of that enterprise will only be taxable in its Residence State. Due to the high mobility of enterprises in the digital economy, the Residence State for these enterprises may often, and easily, be in favourable tax jurisdictions.

Nevertheless, the concept of a PE is sometimes only relevant where States have entered into DTAs. In cases where an enterprise conducts business in a State with which its Residence State has not concluded a DTA, the domestic taxation principles of that country should be considered in order to establish whether the profits of that enterprise is subject to tax in the Source State.

⁵⁸ Olivier *International Tax*, op cit note 51 at 322.

⁵⁹ OECD *Commentary on the MTC*, op cit note 56 at 132.

It is submitted that under South African domestic tax law, the income of a non-resident will be subject to tax to the extent that it is attributable to a source situated within South Africa.⁶⁰ The taxing rights of South Africa may then be restricted through the application of a DTA, however, where there is no DTA between South Africa and the Residence State, these taxing rights will not be restricted. The South African taxation framework is considered below.

3.5. Overview of the South African taxation framework

In some countries residence, or domicile, is the test of liability for taxation. In other countries the principle of liability adopted is the source of income. With effect from 1 January 2001, South Africa moved away from a source based system of taxation to a residence based system. In terms of the resident basis of taxation, the receipts and accruals of income derived by South African residents from all sources are subject to tax in South Africa.⁶¹ In other words, South African residents are subject to tax on their worldwide income, irrespective of its source.⁶²

Whereas, in the case of 'non-residents', that is, persons who do not qualify as residents, only receipts and accruals from income derived from sources situated in South Africa are subject to tax, in terms of the definition of 'gross income' in Section 1 of the ITA.

Until 2012, the term "source" was not defined in the ITA. Before 2012, the guidance to determine whether income was from a South African could be obtained in the common law and the deemed source rules in the old section 9 of the Act.

In terms of the South African common law, in order to establish whether an amount is received from a source within South Africa, Watermeyer CJ stated in *CIR v Lever Bros & Unilever Ltd*:⁶³

"When the question has to be decided whether or not money received by a taxpayer is "gross income" within the meaning of the

⁶⁰ Olivier *International tax*, op cit note 51 at 12.

⁶¹ De Koker, *Silke on International Tax*, op cit note 42 at 2.1

⁶² See the definition of 'gross income' in Section 1 of the Act.

⁶³ 1946 14 SATC 1 at 13

definition referred to above, two problems arise which have not always been differentiated from one another in decided cases. The first problem is to determine what the source from which it has been received is and when that has been determined the second problem is to locate it in order to decide whether it is or is not within the Union..."

In the case of *Essential Sterolin Products (Pty) Ltd v CIR*⁶⁴ Corbett CJ provided that:

"...the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income, and . . . this originating cause is the work which the taxpayer does to earn them, the quid pro quo which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these."

Based on the *Essential Sterolin* case and the case of *First National Bank of Southern Africa Ltd v C SARS*⁶⁵ it appears that whether one is considering a unique set of circumstances or the source of income which has been considered before (for instance, the source of interest, dividends or royalties) the following general principles can, and should be applied to determine whether or not an amount was received from a source within South Africa, namely:⁶⁶

- a) in determining the source of an amount, the first step is to determine what is the originating cause of the income and when that has been determined, the second step is to locate it;
- b) in seeking the originating cause and the location of the source of income one must have regard to the overall factual matrix of the circumstances;
- c) against this factual matrix, the originating cause of a particular receipt may not necessarily all occur in the same place and may occur in different countries, in which case, the dominant, or main or

⁶⁴ 1993 55 SATC 357

⁶⁵ 2002 64 SATC 245

⁶⁶ De Koker *Silke on International tax*, op cit note 42 at 2.1.

substantial or real and basic cause of the accrual of income must be determined; and

- d) one should not lose sight of the fact that ascertaining the actual source of a given income is a practical, hard matter of fact where it may be necessary to adopt a common sense approach.

On 10 January 2012 the Taxation Laws Amendment Act, 24 of 2011, substituted section 9 of the ITA. Section 9 of the Act now provides source rules for the South African domestic law in certain circumstances.

Section 9(2) of the Act provides that an amount is received by or accrues to a person from a source within South Africa if that amount, *inter alia*:

- a) *constitutes a dividend received by or accrued to that person;*
- b) *constitutes interest as defined in section 24J where that interest-*
 - i) *is attributable to an amount incurred by a person that is a resident, unless the interest is attributable to a permanent establishment which is situated outside the Republic; or*
 - ii) *is received or accrues in respect of the utilisation or application in the Republic by any person of any funds or credit obtained in terms of any form of interest-bearing arrangement;*
- c) *constitutes a royalty that is attributable to an amount incurred by a person that is a resident, unless that royalty is attributable to a permanent establishment which is situated outside the Republic;*
- d) *constitutes a royalty that is received or accrues in respect of the use or right of use of or permission to use in the Republic any intellectual property as defined in section 23I;*
- ...
- h) *is received or accrues in respect of services rendered to or work or labour performed for or on behalf of any employer-*
- ...
- j) *constitutes an amount received or accrued in respect of the disposal of an asset that constitutes immovable property held by that person or any interest or right of whatever nature of that person to or in immovable property contemplated in paragraph 2 of the Eighth Schedule and that property is situated in the Republic;*
- k) *constitutes an amount received or accrued in respect of the disposal of an asset other than an asset contemplated in paragraph (j) if-*
 - i) *that person is a resident and-*

- aa) that asset is not attributable to a permanent establishment of that person which is situated outside the Republic; and*
 - (bb) the proceeds from the disposal of that asset are not subject to any taxes on income payable to any sphere of government of any country other than the Republic; or*
- ii) that person is not a resident and that asset is attributable to a permanent establishment of that person which is situated in the Republic;...*

Accordingly, the concept of a PE is also of relevance for the South African domestic law source provisions. A PE is defined in section 1 of the Act as a PE as defined in Article 5 of the OECD MTC.⁶⁷

As stated above, the concept of a PE in terms of a DTA cannot create taxing rights, but only assigns taxing rights created under the domestic laws of a Contracting State.⁶⁸

Therefore, enterprises operating in the digital economy which are tax resident in South Africa would be liable for tax on their worldwide income. However, non-resident enterprises will only be liable for tax in South Africa on South African sourced income.

Where the income of a non-resident is received from a South African source, it should be established whether such taxing rights might be restricted through an applicable DTA. i.e. where an enterprise's Residence State has concluded a DTA with South Africa, and it receives income from a South Africa source, that enterprise will only be subject to tax in South Africa to the extent that its profits are attributable to a PE situated in South Africa.

On the basis that the business profits of an enterprise are not specifically listed in the provisions of section 9 of the Act, the South African case law would have to be considered in order to determine whether the business profits of an enterprise are derived from a South African source.⁶⁹

⁶⁷ De Koker *Silke on International Tax*, op cit note 42 at 18.1.

⁶⁸ Olivier *International Tax*, op cit note 51 at 335.

⁶⁹ *Ibid.*

It is submitted that where a non-resident enterprise in the digital economy provides goods or services to consumers or businesses situated in South Africa, the originating cause of that supply and the corresponding profits may not be caught within the ambit of the current source and PE provisions. It is submitted that in terms of the existing South African domestic taxation framework, enterprises in the digital economy may not derive income from a South African source or its operations may not constitute a PE in South Africa. Although it would have to be tested on a case by case basis, these digital economy enterprises would therefore not be subject to tax in South Africa.

In an attempt to address the shortcoming of the current international and domestic tax framework, the TFDE and DTC have set out to assess whether any amendments are required to address the tax challenges raised by the digital economy.

4. **OECD / G20 BEPS Project - Addressing the tax challenges of the digital economy Action 1: 2015 final report**

4.1. Introduction

During 2013 the OECD identified BEPS as a major risk to tax revenues, tax sovereignty, and tax fairness for OECD member and also non-member countries.⁷⁰

The OECD and G20 commenced work on collecting data on the impact of BEPS as well as identifying ways in which to combat BEPS.⁷¹ The first report published by the OECD was the *Action Plan on Base Erosion on Profit Shifting*. The Action Plan provides that fundamental changes are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices which artificially segregate taxable income from the activities which generate it.⁷²

To this end, the Action Plan set out 15 action points which the OECD and G20 undertook in order to address the challenges posed to the current taxation framework in an effective and efficient manner.⁷³

The Action Plan provides the following description of the work to be undertaken in relation to the digital economy under Action 1:⁷⁴

“Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.”

⁷⁰ OECD (2013) *Addressing Base Erosion and Profit Shifting* at 5.

⁷¹ OECD BEPS report, *op cit* note 70 at 5.

⁷² OECD (2013) *Action Plan on Base Erosion and Profit Shifting* at 13.

⁷³ OECD *Action Plan*, *op cit* note 72 at 13.

⁷⁴ OECD *Action Plan*, *op cit* note 72 at 14.

4.2. Opportunities for BEPS in the digital economy

As stated above, BEPS concerns are raised when taxable income can be artificially segregated from the activities which generate that income. The OECD is of the view that situations in which this occurs undermines the integrity of tax systems and tax revenues.

Furthermore, BEPS activities may distort competition between taxpayers as enterprises operating only in domestic markets or enterprises which refrain from BEPS activities may face competitive disadvantages relative to MNEs which are able to avoid or reduce their taxes by shifting its business profits across borders to more tax favourable jurisdictions.⁷⁵

Although many of the features of business models in the digital economy which provide opportunities for BEPS are also found in traditional business models, some of the key features of the digital economy may exacerbate the risk of BEPS activities. These key features are considered below.

Eliminating or reducing tax in the market country

Eliminating or reducing tax in the market country is often achieved through three main mechanisms which include avoiding a taxable presence,⁷⁶ minimising functions, risks and assets in the market jurisdiction,⁷⁷ and maximising deductions⁷⁸ in market territories.⁷⁹

In many of the business models used in the digital economy, non-resident companies interact with customers in a jurisdiction remotely through an online presence or digital mean without the need for a

⁷⁵ OECD *Digital Economy Report*, op cit note 3 at 78.

⁷⁶ In terms of the OECD *Digital Economy Report* at 79, avoiding a taxable presence could be achieved by conducting business in a country in such a manner that no physical presence is established which would create a taxable presence in terms of the domestic laws of that country or by avoiding establishing a PE.

⁷⁷ The OECD *Digital Economy Report* provides at 80 that MNEs may establish a local subsidiary or PE, with the activities structured in a way that little or no profits are attributed to that subsidiary or PE in terms of Article 7 of the OECD MTC, through an allocation of functions, assets and risks to entities in favorable tax jurisdictions.

⁷⁸ In terms of the OECD *Digital Economy Report* at 81, where a taxable presence has been established, a technique to reduce the taxable income of that entity is to maximise the use of deductions for payments made to other group companies in favourable tax jurisdictions in the form of interest, royalties, service fees, etc.

⁷⁹ OECD *Digital Economy Report*, op cit note 3 at 78.

physical presence in that jurisdiction. The domestic tax law of most jurisdictions, DTAs concluded between states, and the OECD MTC require some degree of physical presence before business profits can be subject to taxation in the source country.⁸⁰ As set out above, Article 5 and Article 7 of the OECD MTC provides that a non-resident enterprise is only subject to tax on its business profits if it has a PE in that country and the profits are attributable to such PE. Accordingly, the enterprise may not be subject to tax in the country where the customers are located and where the profits are derived.⁸¹

While the ability of a company to earn revenue from customer in a country without having a PE in that country is not specific to the digital economy, it is available at a greater scale under the business models utilised in the digital economy. Where this ability, to operate in a Source State without having a taxable presence, is coupled with strategies to reduce or avoid tax in the Residence State, it results in profits not being taxed anywhere in the world and therefore raises BEPS concerns.⁸²

In other cases, MNEs may maintain a degree of presence in a country, utilising a local subsidiary or PE to perform certain functions such as advertising. However, the ability of a MNE to allocate key functions in a way that minimises taxation creates opportunities to manipulate an allocation of functions for tax purposes in ways that may not correspond to the actual business functions performed and would not have been so chosen in the absence of tax considerations.⁸³

MNEs may allocate functions, assets and risks contractually in order to minimise the income allocated to that PE or local subsidiary in order to reduce the taxable income. Examples of business models in the digital economy which may be used to minimise the tax burden in a source jurisdiction through the contractual allocation of functions, assets and risks for purposes of profit attribution include using a subsidiary or PE to perform marketing or technical support, with the

⁸⁰ OECD *Digital Economy Report*, *op cit* note 3 at 79.

⁸¹ *Ibid.*

⁸² *Ibid.*

⁸³ OECD *Digital Economy Report*, *op cit* note 3 at 80.

principal enterprise bearing all the risks and claiming ownership of all intangible assets. Accordingly, the current attribution rules may in itself not suffice to combat the minimisation of income allocated to local operations.⁸⁴

In some instances where there is an existing taxable presence, some MNEs reduce its taxable income by making use of deductions for payments made to other group companies in the form of interest, service fees, royalties, etc. These charges are often paid by companies in high tax jurisdictions to affiliates in low or favourable tax jurisdictions.⁸⁵

Avoiding withholding tax

An enterprise may be subject to withholding taxes in countries where it is not a resident for tax purposes. These withholding taxes may be levied on interest, royalty and service fee payment made by payers in that country. The enterprise may however be entitled to a reduced rate of the withholding tax or the payment may be exempt from withholding tax under the application of a DTA. In order to obtain the benefit of the reduced rate or exemption, enterprises in the digital economy may often interpose a company between the Residence State and Source State, an exercise often referred to as “treaty shopping”.⁸⁶

Eliminating or reducing tax in the intermediate country

MNEs can eliminate or reduce tax in intermediate countries through the application of preferential domestic tax regimes⁸⁷, the use of hybrid mismatch arrangements⁸⁸, or through excessive deductible

⁸⁴ OECD *Digital Economy Report*, op cit note 3 at 80.

⁸⁵ OECD *Digital Economy Report*, op cit note 3 at 81.

⁸⁶ *Ibid.*

⁸⁷ The OECD *Digital Economy Report* provides at 82 that MNEs may utilise the arbitrage between the domestic rules of the intermediate country and the ultimate residence country to create stateless income. MNEs may also assert that the functions, assets, and risks assumed in the intermediate country are limited.

⁸⁸ The OECD *Digital Economy Report* provides at 82 that MNEs may avoid taxes by utilising hybrid mismatch arrangements to generate deductible payments with no corresponding inclusion in the country of the payee.

intra-group payments⁸⁹ to connected persons in low or favourable tax jurisdictions.

One of the key features of the digital economy is the extremely high reliance on intangibles. This creates some tax planning opportunities as the ownership and rights of intangibles and their related returns can be assigned and transferred among associated enterprises and may be transferred to connected persons in low tax jurisdictions.⁹⁰

Eliminating or reducing tax in the country of residence of the ultimate holding company or parent

The techniques utilised to reduce the tax liability in source and intermediate countries can equally be applied to reduce the tax liability in the country of the holding or parent company. This may involve contractually allocating risks and legal ownership of intangibles to group entities in favourable tax jurisdictions, whilst the parent company remains uncompensated for its role in bearing the risks or for its role in the development, enhancement and protection of the intangibles.⁹¹ When risks and ownership of intangible assets are contractually allocated to other entities, it will reduce the amount of business profits attributable to that holding or parent company in terms of Article 7 of the OECD MTC.

4.3. Tax challenges raised by the digital economy

The prevalence of new business models within the digital economy have resulted in non-resident enterprises being able to operate in a geographical jurisdiction in a fundamentally different way than at the time when international tax rules were designed. Enterprises in the digital economy are able to trade in a jurisdiction without any physical presence there on a much larger scale than previously envisaged.

MNEs are now able to manage many functions, such as procurement,

⁸⁹ In terms of the *OECD Digital Economy Report* at 81, a company may reduce taxes by generating excessive deductible payments. For example, an operating company may use intangibles held by an affiliate in a favourable tax jurisdiction. The royalties for the use of these intangibles may be utilised to eliminate taxable profits in the intermediate country as the payment of royalties should qualify for deduction from the taxable income of that entity.

⁹⁰ *OECD Digital Economy Report*, *op cit* note 3 at 81.

⁹¹ *OECD Digital Economy Report*, *op cit* note 3 at 82.

marketing and distribution, centrally, where it previously required a local presence in the Source State to perform these functions. A physical connection or *nexus* is no longer required between the non-resident enterprise and the Source State.

Other key features in the digital economy, such as the reliance on data, may raise challenges for tax policy makers with regard to both the characterisation of and attribution of value to data. The new revenue streams adopted from the multi-sided business models and the use of broadband connections raise questions with regard to the appropriate characterisation of certain transactions and payments for tax purposes.⁹²

The challenges posed by the digital economy raise questions in relation to the allocation of taxing rights between source and residence States, as well as use of attribution principles which attributes income to a PE by analysing of the functions, assets and risks to determine where economic activities are carried out and the value attached thereto.⁹³

With regard to direct taxation, the main tax policy issues raised by the digital economy relate to three main categories, namely *nexus*, data and characterisation. These categories are considered below.⁹⁴

Nexus and the ability to have a significant presence without being liable to tax

The essential of business has remained the same, even with advances in ICT. Businesses still need to perform certain support functions such as marketing, customer support and research to support their sales activities. The advances in ICT have however impacted on how these activities are carried out, as advances in ICT now allows enterprises to carry out these functions remotely, distance no longer being a barrier to trade. A physical presence and personnel

⁹² OECD *Digital Economy Report*, op cit note 3 at 99.

⁹³ *Ibid.*

⁹⁴ *Ibid.*

are no longer required in a country to the same extent as was previously necessary.⁹⁵

Enterprises are now able to choose where to set up their business activities, even if that location is removed from the ultimate market jurisdiction. People functions have also been significantly reduced, with many processes, even the acceptance of contracts, becoming automated.⁹⁶

It should be noted that some MNEs may however still maintain a taxable presence in the jurisdiction where its customers are located.

The main challenges posed by the digital economy relate to the definition of a PE for purposes of a DTA and the related profit attribution rules. As it is now possible to conduct a full scale business in a country without having a fixed place of business or a dependant agent therein, the current definition of a PE may no longer be appropriate.⁹⁷

Furthermore, services which was previously considered preparatory or auxiliary and therefore specifically excluded from the definition of a PE in Article 5(4) of the OECD MTC and most DTAs, for certain industries be increasingly significant components of business in the digital economy. For example, an online retailer may require a warehouse close to its customers, and as such that warehouse may no longer be auxiliary but in actual fact be a crucial part of its business.⁹⁸

The problem of a *nexus* goes beyond DTAs, as many countries' domestic laws would not regard many of the activities performed by MNEs in the digital economy as a significant enough *nexus* as to render that MNE subject to tax under the domestic tax rules. As a result, the issue of *nexus* would need to be addressed both from a DTA perspective as well as from a domestic perspective, as DTAs cannot create a tax liability.⁹⁹

⁹⁵ OECD *Digital Economy Report*, *op cit* note 3 at 100.

⁹⁶ *Ibid.*

⁹⁷ *Ibid.*

⁹⁸ OECD *Digital Economy Report*, *op cit* note 3 at 102.

⁹⁹ *Ibid.*

Data and the attribution of value created from the generation of marketable location relevant data through the use of digital products and services

Advances in ICT enable the collection, storage and use of data remotely through various different methods. The data collected from various sources is often utilised in the process of value creation in the digital economy. Leveraging the data may create value for businesses in a number of ways, which includes allowing businesses to provide targeted offerings and to improve products and services. The expanding role of data in the value chain of MNEs raises questions about whether the current rules in relation to the attribution of profits to a PE are appropriate in relation to remote data gathering. It poses the challenge of considering whether the data being used is appropriately characterised and valued for tax purposes.¹⁰⁰

The value of data collected by a business would not be reflected on the balance sheet of a business and would therefore not be relevant for determining the profits of the enterprise for accounting and tax purposes. Furthermore, in terms of the data protection legislation of most countries, the personal data of consumers is protected and the information is regarded as being the property of the individual from whom it is derived, rather than an asset owned by an enterprise.¹⁰¹

The value of data collection raises questions regarding whether the remote collection of data should give rise to a nexus for tax purposes even where the enterprise has no physical presence and what the impact of such a nexus would be on the attribution principles for attributing value to such nexus.¹⁰²

Characterisation of income derived from new business models

Advances in ICT has allowed enterprises to monetise products and services in new ways. New business models raises questions about how to characterise certain transactions and payments for domestic and DTA purposes. For example a question which arises is whether a

¹⁰⁰ OECD *Digital Economy Report*, op cit note 3at 103.

¹⁰¹ *Ibid.*

¹⁰² *Ibid.*

payment for the use of cloud computing should be characterised as a royalty fee, fees for technical services or business profits.¹⁰³

In terms of the OECD MTC, and most DTAs, business profits will be taxable in the Source State only to the extent that those business profits are attributable to a PE located in that Source State. Royalties and service fees on the other hand may be subject to withholding taxes in the Source State. The characterisation of the income is therefore of great importance for tax purposes.¹⁰⁴

4.4. Options to address tax challenges raised by the digital economy

The TFDE considered various options to address the tax challenges raised by the new business models and key features of the digital economy. As there are various overlaps between the challenges relating to nexus, data and characterisation, the options put forward by the TFDE attempt to address all of these challenges holistically.¹⁰⁵

Some of the options to address the tax challenges raised by the digital economy have been addressed by the work done in terms of other points under the Action Plan. For example, one of the challenges raised by the digital economy is that some of the functions performed qualify for the exemptions from a PE under the OECD MTC, even though these functions are not preparatory or auxiliary in the value chain of the enterprise. With regard to addressing the appropriateness of the exceptions from PE status, work has been conducted in relation to Action 7 of the BEPS project. The task force working on Action 7 analysed whether activities that may previously have been preparatory or auxiliary should continue to benefit from exceptions contained in article 5(4) of the OECD MTC to the PE definition where they have become core components of an enterprise. As a result of the work conducted under Action 7, the exceptions have been modified to

¹⁰³ OECD *Digital Economy Report*, *op cit* note 3 at 106.

¹⁰⁴ *Ibid.*

¹⁰⁵ *Ibid.*

ensure that they are only available for activities which are truly preparatory or auxiliary.¹⁰⁶

The options put forward by the TFDE for addressing the tax challenges raised by the digital economy are considered below.

4.4.1. A new nexus based on the concept of a significant economic presence

Under this proposal, a taxable presence would be created in a jurisdiction when a non-resident enterprise has a 'significant economic presence' in that jurisdiction based on certain factors which evidence a purposeful and sustained interaction with the economy of that jurisdiction. These factors will be considered in concert with a revenue based factor in order to ensure that only cases of significant economic presence are covered and to provide certainty for taxpayers conducting cross-border activities.¹⁰⁷

Revenue based factor

Revenue generated on a consistent basis from a jurisdiction could be considered to be a substantial indicator of the existence of a significant economic presence. Revenues will however, in isolation, not be sufficient to establish a nexus to the Source State, but could be considered a factor to be taken into consideration in combination with other factors in order to establish a nexus in the form of a significant economic presence in the jurisdiction concerned. Using revenue as a basic factor would provide taxpayers with certainty in considering whether a significant economic presence exists.¹⁰⁸

Digital factors

The ability of bricks and mortar businesses to reach a significant number of customers in a jurisdiction depends on a variety of factors, including a store's location, marketing, payment options, and customer service. In the digital economy, the ability of enterprise to establish a sustained interaction with customers in a jurisdiction via an online

¹⁰⁶ OECD *Digital Economy Report*, op cit note 3 at 107.

¹⁰⁷ *Ibid.*

¹⁰⁸ OECD *Digital Economy Report*, op cit note 3 at 108.

presence similarly depends on a number of factors. This range of factors could be used as part of a test for a significant economic presence.¹⁰⁹ These factors are considered below.

- A local domain name

Non-resident MNEs who target customers in a jurisdiction will generally obtain a localised domain name, which is analogous to a bricks and mortar store obtaining a location in-country. A local domain name will make the website more accessible to local users and will also assist in protecting the intellectual property of the MNE in that jurisdiction.¹¹⁰

- A local digital platform

Non-resident MNEs may establish “local” websites, application stores or other digital platforms in order to present goods or services in a targeted manner to the specific local consumers of that jurisdiction, taking into account factors such as culture and language. The local digital platform may also contain localised terms of service for users that reflect the commercial and legal context of the local environment. Local platforms may however also be established for districts or areas which do not correspond to political jurisdictional boundaries.¹¹¹

- Local payment options

Non-resident MNEs maintaining a sustained interaction with consumers in a jurisdiction will frequently ensure that the local consumers have a smooth purchasing experience with prices reflected in the local currency, taxes and fees already included in the purchase price, with the option of using a local payment option to conclude the transaction. Integrating the local payment options into a digital platform’s commercial feature is a complicated process from a technical, commercial and legal point, requiring substantial resources. MNEs would therefore

¹⁰⁹ OECD *Digital Economy Report*, *op cit* note 3 at 109.

¹¹⁰ *Ibid.*

¹¹¹ *Ibid.*

normally only undertake such an investment where it purposefully participates in the jurisdiction's economy.¹¹²

This is particularly relevant in countries where there are strict banking regulations, currency controls or a low penetration of international credit cards.¹¹³

User-based factors

Due to the importance of network effects in the digital economy, the user base and associated data may be important indicators of a purposeful and sustained interaction in the economy of another jurisdiction.¹¹⁴ There are a number of user-based factors which reflects the level of participation in the economy and may therefore be indicative of a significant economic presence. These factors are considered below.

- Monthly active users

A factor reflecting the level penetration in an economy is the number of monthly active users on the digital platform. Should this factor be used as a metric, detailed research would need to be performed in order to establish guidelines for what constitutes "monthly active users" and how it should be measured.¹¹⁵

- Online contract conclusion

Another factor which may indicate the level of participation of an MNE in an economy is the regular conclusion of contracts. The conclusion of contracts is the primary focus of the existing dependant agent PE framework in article 5 of the OECD MTC.¹¹⁶

In the digital economy contracts are frequently concluded with consumers via a digital platform without the need for intervention by local personnel or dependant agents in the

¹¹² OECD *Digital Economy Report*, op cit note 3 at 109.

¹¹³ OECD *Digital Economy Report*, op cit note 3 at 110.

¹¹⁴ *Ibid.*

¹¹⁵ OECD *Digital Economy Report*, op cit note 3 at 110.

¹¹⁶ *Ibid.*

jurisdiction where the consumer is based. The number of contracts concluded with consumers in a jurisdiction in a tax year could be considered an important factor for determining whether a significant digital presence exists.¹¹⁷

- Data collected

The volume of data and other digital content collected via a digital platform by an enterprise could also be a factor to take into consideration. The focus if this factor would be the origin of the data collected, irrespective of where the data is subsequently stored and processed. However, one of the challenges of this factor is that enterprises may not store the data collected on a country-by-country basis.

Possible combination of revenue, digital, and user based factors

Total revenue in excess of the revenue threshold may in itself not suffice to show that a non-resident enterprise carries on a regular and sustained participation in an economy. In order to establish the most accurate measure of an enterprise's participation in an economy, the revenue factor should be taken into consideration in combination with the digital and user based factors. Accordingly, a link would have to be created between the revenue generating activities of a non-resident enterprise and its significant economic presence in the jurisdiction.¹¹⁸

An example would be where a non-resident enterprise generates revenues in a jurisdiction which exceeds the revenue threshold by entering into transactions with consumers who are required to use a personalised account and make use of local payment solutions in the local currency of that jurisdiction. Accordingly there would be a link between the revenue generated and the digital and user based factors evidencing a significant economic presence of the enterprise in that jurisdiction.¹¹⁹

¹¹⁷ OECD *Digital Economy Report*, op cit note 3 at 110.

¹¹⁸ OECD *Digital Economy Report*, op cit note 3 at 111.

¹¹⁹ *Ibid.*

4.4.2. Determining the income attributable to the significant economic presence

The attribution of profits is an important consideration in developing a nexus based on a significant economic presence in a jurisdiction. Consideration must be given to what changes would be required to the profit attribution rules if the significant economic presence option were to be adapted as a nexus.

Existing rules and principles

A significant economic presence associated with little or no physical presence with reference to tangible assets and personnel in the other jurisdiction is not likely to involve the carrying on of any functions of an enterprise in the traditional sense. As such, under the existing rules for attribution of profits to PEs, it would not be possible to allocate any meaningful income to the new nexus.¹²⁰

The existing rules and principles for profit attribution are set out in article 7 of the OECD MTC and involves an analysis of the functions, assets and risks of the enterprise concerned. Some of the options to address the attribution of profits for a nexus based on a significant economic presence are considered below.

Methods based on fractional apportionment

A possible approach could be to apportion the profits of the whole enterprise to the digital presence either on the basis of a predetermined formula, or on the basis of variable allocation factors determined on a case-by-case basis. This would require the implementation of three steps, namely (1) the definition of the tax base to be divided, (2) the determination of the allocation keys to divide that tax base, and (3) the weighting of these allocation keys.¹²¹

The fractional apportionment approach would constitute a departure from the existing OECD MTC and domestic laws of most jurisdictions as the current international standards use profit attribution methods

¹²⁰ OECD *Digital Economy Report*, *op cit* note 3 at 112.

¹²¹ *Ibid.*

based on the separate accounts of the PE, rather than a fractional apportionment. Due to a number of difficulties which this approach may produce, the TFDE did not pursue this approach further.¹²²

Modified deemed profit methods

The use of ‘deemed profit systems’ can be utilised as a way to avoid profit computations based on a taxpayer’s accounts in cases where a high proportion of expenses associated with revenues are incurred in the source jurisdiction, making a local audit difficult.¹²³

For purposes of a nexus based on a significant economic presence, a possible approach would be to regard the presence to be comparable to a physical presence from which the non-resident enterprise is operating a commercial business and then determining the deemed net income by applying a ratio of presumed expenses to the non-resident enterprises’ revenue derived from transaction entered in to with consumers in a jurisdiction.¹²⁴

4.4.3. A withholding tax on digital transactions

A withholding tax levied on payment made by resident and local PEs of a jurisdiction for goods and services purchased on a digital platform is another potential option for collecting taxes from enterprises in the digital economy. The withholding tax on digital transactions (“Digital Withholding Tax”) would be implemented as a gross basis final withholding tax on certain payments made to non-resident providers of goods and services ordered on a digital platform. Alternatively, the Digital Withholding Tax could be implemented on a net-basis taxation, as an enforcement tool to support the application of the nexus of a significant economic presence. This option does however raise some issues with regard to the scope of transactions covered and the collection of the tax. These issues are considered below.

¹²² OECD *Digital Economy Report*, op cit note 3 at 112.

¹²³ *Ibid.*

¹²⁴ *Ibid.*

Scope of transaction covered

The scope of transactions covered by the Digital Withholding Tax must be clearly identified and defined in order to provide certainty of its application to taxpayers and withholding agents. It should also be defined simply and clearly in order to avoid classification disputes, however still ensuring that similar transactions are classified and taxed similarly.¹²⁵

In order to avoid classification disputes, the TFDE considers a general definition of covered transactions to be the most appropriate approach, rather than establishing a list of specific transactions.¹²⁶

The Digital Withholding Tax can be applied to transactions for goods and services ordered on a digital platform, or to all sales operations concluded remotely with non-resident enterprises. The TFDE considers the latter to be appropriate as it has the advantage of being flexible, and would ensure tax neutrality between similar ways of doing business, and may reduce disputes over characterisation.¹²⁷

Collection of tax

The liability to pay a withholding tax is, in practice, often shifted to the consumer or collecting agent. Therefore, in order for the Digital Withholding Tax to be implemented successfully, the withholding agent must have access to information about the covered transactions in order to efficiently apply the Digital Withholding Tax.¹²⁸

In B2B transactions, businesses in the Source State could be reasonably expected to comply with its withholding obligations. This could however be problematic where the withholding agent is a private individual who has little knowledge of the application of withholding taxes nor has he any incentive to pay such taxes. A possible solution to this would be to require intermediaries processing the payment to withhold the tax on B2C transactions.¹²⁹

¹²⁵ OECD *Digital Economy Report*, op cit note 3 at 113.

¹²⁶ *Ibid.*

¹²⁷ *Ibid.*

¹²⁸ OECD *Digital Economy Report*, op cit note 3 at 114.

¹²⁹ *Ibid.*

4.4.4. Introduction of an “equalisation levy”

In order to mitigate some of the difficulties arising from creating new profit attribution rules for purposes of the nexus based on a significant economic presence, the TFDE considered the introduction of an ‘equalisation levy’. This approach is used to ensure the equal treatment of resident and non-resident suppliers. An equalisation levy would be utilised to serve as a way to tax only non-resident enterprises with a significant economic presence, after the revenue, digital and user based factors have been considered.¹³⁰

Scope of the levy

If the tax policy is to tax remote sales transactions, the levy could be applied to all transactions concluded remotely with in-country consumers where the supplier maintains a significant digital presence in the jurisdiction.

Potential trade and other issues

Similar to the imposition of a gross-level Digital Withholding Tax, a levy applied only to non-resident enterprises may create issues with respect to trade agreements and non-discrimination principles under the EU law. Options to achieve equal treatment between resident and non-resident enterprises would be to apply the levy to both, and then mitigating the impact of the income under corporate income tax rules.¹³¹

Relationship with corporate income tax

Imposing the equalisation levy raises the risk of double taxation for resident and non-resident enterprises. As the levy would unlikely be creditable against corporate income tax, it would be necessary to structure the levy to apply only to situations where the income would otherwise be untaxed or subject only to a low rate of taxation.¹³²

Alternatively, taxpayers subject to both the levy and to corporate income tax on that income should be allowed to credit the levy against

¹³⁰ OECD *Digital Economy Report*, op cit note 3 at 115.

¹³¹ OECD *Digital Economy Report*, op cit note 3 at 116.

¹³² OECD *Digital Economy Report*, op cit note 3 at 117.

its domestic corporate income tax. This approach would ensure that non-resident enterprises with no nexus for corporate income tax purposes would be subject to the levy in the Source State.¹³³

4.5. Conclusion

The TFDE considered several options to address the broader tax challenges raised by the digital economy. To evaluate these options, the TFDE agreed to apply the Ottawa principles of tax policy, which framework is based on neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability, and proportionality.

The TFDE concluded that some of the tax challenges raised by the digital economy are expected to be mitigated once all the BEPS measures under the Action Plan are implemented.¹³⁴

The TFDE has not recommended any of the options discussed above for implementation at this stage. The decision not to implement any of these options is based on the expectation that the tax challenges will be mitigated with the implementation of other BEPS Action points.¹³⁵

The TFDE did however recommend that countries could introduce any of the above options in their domestic laws as additional safeguards against BEPS, provided existing treaty obligations are taken into consideration.¹³⁶

The TFDE will continue work on the tax challenges raised by the digital economy in terms of which it will monitor the impact of the other BEPS Action Points on the digital economy. A report reflecting the outcome of the continued work is expected to be released in 2020.¹³⁷

¹³³ OECD *Digital Economy Report*, *op cit* note 3 at 117.

¹³⁴ OECD *Digital Economy Report*, *op cit* note 3 at 148.

¹³⁵ *Ibid.*

¹³⁶ *Ibid.*

¹³⁷ OECD *Digital Economy Report*, *op cit* note 3 at 149.

6. Addressing BEPS in South Africa Davis Tax Committee Interim Report – Action 1: Address the tax challenges of the digital economy

6.1. Introduction to the Davis Tax Committee

During the 2013 budget the Minister of Finance announced the Government's intention to set up a committee to review the existing tax framework in South Africa. The DTC, chaired by Judge Dennis Davis, was appointed on 17 July 2013 with its main mandate being to assess the South African tax system.¹³⁸

The DTC has set up a number of sub-committees which are focused on different areas of taxation in South Africa, one such sub-committee is currently assessing the work of the OECD BEPS Project, and has released interim reports for public comment¹³⁹ on some of the BEPS action points. The interim reports set out the DTC's interpretation and application of the BEPS reports in the South African landscape.¹⁴⁰

The interim report on Action 1: Address the tax challenges of the digital economy ("DTC Report") was one of the interim reports released for public comment by the DTC.

6.2. Background of e-commerce in South Africa

In 1997, the Katz Commission was tasked with assessing the South African tax framework, and based on the recommendations made in the Katz Commission's report a white and green paper (legislative instruments) was developed with the intention of establishing a legislative framework for e-commerce in South Africa. The white paper was aimed at creating a new legal framework to address electronically concluded transactions, and its main focus was on

¹³⁸ Davis Tax Committee, Interim report, Addressing Base Erosion and Profit Shifting in South Africa, 2014 at 1.

¹³⁹ The interim reports released by the DTC include:

- Action 1 - Digital Economy
- Action 2 - Hybrid Mismatches
- Action 5 - Harmful Tax Practices
- Action 6 - Treaty Abuse
- Action 8 - Transfer Pricing of Intangibles
- Action 13 - Transfer Pricing Documentation
- Action 15 - Multilateral Instrument

¹⁴⁰ *Ibid.*

creating ways of identifying parties in e-commerce transactions, as identifying the party was the starting point for collecting taxes.¹⁴¹ The green / white paper was however never enacted into legislation which provided for the taxation of e-commerce transactions.¹⁴² The paper was however used as the basis for the development of the Electronic Communications and Transactions Act, 25 of 2002.

6.3. Direct tax: taxing income derived from e-commerce – the DTCs interpretation of the current position in South Africa

South African residents

The DTC is of the meaning that there is very limited scope for tax planning by residents to shift profits to favourable tax jurisdictions via e-commerce transactions. Due to the extensive CFC legislation enacted in section 9D of the Act¹⁴³ in conjunction with the transfer pricing legislation in section 31 of the Act,¹⁴⁴ it is difficult for residents to shift profits to offshore companies unless significant substance is also transferred to such a CFC with a substantial business operation in that favourable tax jurisdiction.¹⁴⁵

The DTC Report recommends that it may be necessary to revisit the foreign tax credit rules¹⁴⁶ and CFC rules in order to make provision for

¹⁴¹ Davis Tax Committee, Interim report, Addressing Base Erosion and Profit Shifting in South Africa, Action 1: Address the tax challenges of the digital economy 2014 at 25.

¹⁴² DTC Report, *op cit note 138* at 25.

¹⁴³ Section 9D of the Act provides that there shall be included in the income for the year of assessment of any resident who directly or indirectly holds any participation rights in a CFC the proportional amount of the net income of that CFC determined for its foreign tax year. Therefore, if residents shift profits to offshore subsidiaries, the net income of that CFC will be included in the income of the South African resident, subject to certain exclusions.

¹⁴⁴ Section 31 of the Act provides that where any transaction, operations, scheme, agreement or understanding constitutes an affected transaction and any term or condition of that transaction will result in any tax benefit being derived by a person that is a party to that transaction, the taxable income or tax payable by the person that derived a tax benefit must be calculated as if the transaction had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length.

¹⁴⁵ DTC Report, *op cit note 140* at 26.

¹⁴⁶ The current foreign tax credit rules in the domestic law is enacted in section 6quat of the Act and provides that where the taxable income of any resident includes, *inter alia*, any income received by or accrued to from any source outside of South Africa, there must be deducted from the normal tax payable in respect of that taxable income a rebate determined in terms of section 6quat.

e-commerce transactions, especially if the international tax framework is amended as to provide more taxing rights to source countries.¹⁴⁷

Non-residents

As set out above, non-residents conducting e-commerce transactions “within” South Africa or with South African customers are only liable to tax in South Africa on South African sourced income.¹⁴⁸

The common law source principles and the source provisions enacted in section 9 of the Act should be read in conjunction with an applicable DTA if one has been concluded between South Africa and the Residence State of the enterprise.¹⁴⁹

In order to be subject to tax on South African, under the current taxation framework, it is generally required that the non-resident conduct some activity or operation through a physical local presence before the business profits would be regarded as being derived from a South African source.¹⁵⁰

The source provisions in section 9 do not however make provision specifically for electronic transactions. Accordingly, the common law principles on source must be relied on. As set out above, the common law principle requires that you establish the originating cause, and once the originating cause has been established, it should be determined where that originating cause is located. This test does however not take into account the complexities of the digital economy.¹⁵¹

Therefore, the current South African taxation framework does not allow for the taxation of income derived by non-residents from e-commerce transactions with South African residents. Companies operating in the e-commerce sphere can therefore avoid tax in South Africa if the originating cause of the income is not in South Africa. In terms of e-commerce transactions, the originating cause would

¹⁴⁷ DTC Report, *op cit* note 138 at 26.

¹⁴⁸ *Ibid.*

¹⁴⁹ *Ibid.*

¹⁵⁰ DTC Report, *op cit* note 138 at 27.

¹⁵¹ *Ibid.*

generally be where the server is located. Often, the servers are located in favourable tax jurisdictions.¹⁵²

In terms of Articles 5 and 7 of the OECD MTC, which is typically used in most of South Africa's DTAs, a company resident in the other Contracting State is only subject to tax on business profits derived in South Africa if it has a PE situated in South Africa and that income is attributable to that PE. As a PE is defined for South African domestic tax purposes as a PE as defined in article 5 of the OECD MTC, any challenges raised by the digital economy in relation to the application of Article 5 of the OECD MTC would also, *mutatis mutandis*, apply to South African domestic tax laws.¹⁵³

6.4. DTC Recommendations on direct taxes for the digital economy in South Africa

The challenges which the digital economy poses to the existing taxation framework are of an international nature, and the DTC therefore recommends that South Africa awaits the outcomes of the OECD's on-going work on the PE threshold for the digital economy (i.e. the nexus based on a significant economic presence). The DTC Report provides that a multilateral, rather than a unilateral approach should be followed to address the challenges raised by the digital economy.¹⁵⁴ The DTC Report made the following conclusions with regard to the tax challenges raised by the digital economy, with specific reference to challenges to direct taxation.

6.4.1. Amendment of the PE definition

Amending the definition a PE in DTAs, in order to make provision for the key features of the digital economy will assist in addressing the challenges raised by the digital economy.

It is recommended that South Africa should work hand in hand with other nations in order to formulate a feasible way of taxing e-commerce transactions. Any amendments which are implemented

¹⁵² DTC Report, *op cit* note 138 at 27.

¹⁵³ *Ibid.*

¹⁵⁴ *Ibid.*

should take cognisance of the developing nature of the digital economy in order to ensure that the proposed changes could keep up with the changing nature of ICT.¹⁵⁵

The DTC also recommended that the exclusions to the PE definition in Article 5(4) of the OECD MTC, and most of South Africa's DTAs should be reconsidered, in order to determine whether those exclusions remain appropriate with reference to e-commerce.

6.4.2. Source rules

In order for the South African revenue authorities to levy tax on non-resident suppliers of goods and services via e-commerce to South African customers, the existing source rules need to be amended to address the taxation of the digital economy.¹⁵⁶

It is proposed that the source rules in section 9 of the Act be expanded to enact rules which cover proceeds derived from the supply of digital goods and services derived from a source in South Africa. The new source rules should legislate that the source of digital transactions is where the consumption of the digital goods or services take place, i.e. where the consumer is physically present at the time of the supply.¹⁵⁷

It is also proposed that the new source rules should provide clarity on the characterisation of the typical income flows in the digital economy.

The source rules would form the basis on which the other OECD recommendations are implemented.¹⁵⁸

The DTC Report notes that discretion should be exercised in the design and application of the source rules so that only an appropriate portion of the profits realised in taxable as South African source income. It is acknowledged that it would not be appropriate to include the full proceeds realised from supplies to South African customers as the Residence State of the supplier would also have a legitimate claim to tax a portion of the proceeds if that State operates on a Residence

¹⁵⁵ DTC Report, *op cit* note 140 at 28.

¹⁵⁶ *Ibid.*

¹⁵⁷ *Ibid.*

¹⁵⁸ *Ibid.*

basis of taxation, where residents are liable to tax in the Resident State on their worldwide income.¹⁵⁹

6.4.3. Administrative considerations

The effective enforcement and collection of taxes are a challenge for in the digital economy. The DTC recommends that legislation should be enacted to require non-resident companies that earn South African sourced income (excluding passive income) to submit income tax returns even where that non-resident does not have a PE in South Africa. This would ensure information capturing of all non-residents active in the South African economy.¹⁶⁰

6.4.4. Withholding tax

The DTC recommends that a system be created which imposes an obligation on a resident transacting with a non-resident to withhold tax on any payment to a non-resident.¹⁶¹

6.4.5. Electronic Communications and Transactions Act

As one of the major challenges in the digital economy is identifying the suppliers and their location in the digital economy, the DTC suggests that the Act be amended to provide that the provisions of the Electronic Communications and Transactions Act be taken into consideration for the detection and identification of business in the digital economy. The benefit of implementing taxing provisions should however not outweigh the benefit received from such taxing provisions.

6.5. Conclusion

The DTC recommendations are based largely on tOECD's Public Discussion Draft on BEPS Action 1. The OECD published the Digital Economy Report subsequent to the DTC's interim report, with various new proposals and conclusions not yet addressed in the DTC Report.

¹⁵⁹ *Ibid.*

¹⁶⁰ DTC Report, *op cit* note 140 at 28.

¹⁶¹ *Ibid.*

The DTC report raises important considerations for the domestic law amendments to the source provisions, as DTAs cannot impose tax, and can only assign taxing rights between Contracting States. Without the necessary amendments to the source provisions, amendments to the PE definition may not be effective as the income would only be subject to tax if it is derived from a South African source.

7. Comparative analysis and application to the South African taxation framework

7.1. Permanent Establishment rules / nexus based on significant economic presence

7.1.1. OECD

The OECD's proposal to address the ability of an enterprise in the digital economy to operate in a country without a physical presence is to establish a taxable presence which would be created in a jurisdiction when a non-resident enterprise has a 'significant economic presence' in that jurisdiction.

An enterprise would have a significant economic presence when it generates revenue on a consistent basis from a jurisdiction together with a range of other factors which include a local domain name, a local digital platform, local payment options, monthly active users, online contract conclusion, and data collected in that jurisdiction.¹⁶²

If a nexus is developed based on a significant economic presence, profit attribution principles also need to be developed in order to efficiently attribute profits to such a nexus.¹⁶³

A possible option for profit attribution would be a fractional apportionment in terms of which the profits of an enterprise as a whole is attributed on the basis of a pre-determined formula or on the basis of a variable allocation which requires the implementation of three steps, namely (1) the definition of the tax base to be divided, (2) the determination of the allocation keys to divide that tax base, and (3) the weighting of these allocation keys.¹⁶⁴

Another approach for profit attribution would be a modified deemed profit method. In terms of this method, the significant economic presence would be deemed to be comparable to a physical presence from which the non-resident enterprise is operating a commercial business and then determining the deemed net income by applying a

¹⁶² OECD *Digital Economy Report*, *op cit* note 3 at 109.

¹⁶³ OECD *Digital Economy Report*, *op cit* note 3 at 112.

¹⁶⁴ *Ibid.*

ration of presumed expenses to the non-resident enterprises' revenue derived from transaction entered in to with consumers in a jurisdiction.¹⁶⁵

7.1.2. DTC

The DTC Report suggested that amendments to the definition a PE in DTAs entered into by South Africa, in order to make provision for the key features of the digital economy will assist in addressing the challenges raised by the digital economy.

The amendments to the PE definition could be constitute adding a clause which address the business models utilised in and the key features of the digital economy. The amendments to the PE definition could also include amending the exclusions to the PE definition in order to limit exclusions utilised by enterprises operating in the digital economy for services which are currently considered to be of a preparatory or auxiliary nature but in actual fact play a substantial role in the value chain of the enterprise in the digital economy.

7.1.3. Application to the South African taxation framework

It is submitted that establishing a nexus based on a significant economic presence or amending the PE definition in the OECD MTC or / and South African DTAs may be an effective approach in addressing the ability of enterprises in the digital economy to conducting substantial enterprises in a country without having a physical presence. One of the main challenges of this option would be the approach utilised to attribute profits to such a nexus or digital PE.

From a South African perspective, as set out in the DTC's report, amending the PE definition or creating a new nexus would not be effective if undertaken unilaterally, and would need to be accepted multilaterally. The OECD's work in developing a multilateral instrument to which many parties could adopt various international instruments simultaneously in terms of Action 15 of the BEPS Action Plan, could assist greatly in overcoming this obstacle.

¹⁶⁵ OECD *Digital Economy Report*, *op cit* note 3 at 112.

The proposal with regard to a nexus or amendments to the PE definition should be considered in unison with the representations made on the 'source' principles in the DTC Report.

The DTC also recommended that the exclusions in Article 5(4) of the OECD MTC be considered in order to determine whether these exclusions remain appropriate. The OECD TFDE also recognised this challenge. However, the work has been allocated to the working group under Action 7 of the Action Plan. The exclusions have been considered and have been found to be inappropriate with reference to the new business models in the digital economy. Amendments to the exclusions to the PE definition have been recommended by the working group on Action 7.

The amendments to the exclusions to the PE definition could be implemented by way of the multilateral instrument proposed in terms of Action 15 of the Action Plan, or bilaterally by negotiating Protocols to the DTAs concluded between South Africa and its treaty partners.

As set out above, DTAs cannot impose tax, and therefore the appropriate charging sections should be introduced in the Act in order to impose tax on South African sourced income in the digital economy.

The DTC Report proposed that the source rules in section 9 of the Act be expanded to enact rules which cover proceeds derived from the supply of digital goods and services derived from a source in South Africa. The new source rules should legislate that the source of digital transactions is where the consumption of the digital goods or services take place, i.e. where the consumer is physically present at the time of the supply.¹⁶⁶

7.2. Withholding taxes

7.2.1. OECD

A withholding tax levied on payment made by resident and local PEs of a jurisdiction for goods and services purchased on a digital platform is another potential option for collecting taxes from enterprises in the

¹⁶⁶ DTC Report, *op cit* note 140 at 28.

digital economy. The Digital Withholding Tax would be implemented either as a gross basis final withholding tax on certain payments made to non-resident providers of goods and services ordered on a digital platform or alternatively as a net-basis taxation.

One of the main challenges for implementing a withholding tax is the fact that the liability to pay a withholding tax is, in practice, often shifted to the consumer or collecting agent. In B2B transactions, businesses in the Source State could be reasonably expected to comply with its withholding obligations. This could however be problematic where the withholding agent is a private individual who has little knowledge of the application of withholding taxes nor has he any incentive to pay such taxes. A possible solution to this would be to require intermediaries processing the payment to withhold the tax on B2C transactions.¹⁶⁷

7.2.2. DTC

The DTC Report only suggested that a system be created which imposes an obligation on a resident transacting with a non-resident to withhold tax on any payment to a non-resident.¹⁶⁸ The DTC Report did not consider the practical ways of implementing such withholding tax nor did it consider the challenges of such a withholding tax.

7.2.3. Application to the South African taxation framework

In contrast with the nexus based on a significant economic presence, it is submitted that a Digital Withholding Tax is capable of unilateral implementation. However, in order to effectively implement a Digital Withholding Tax in South Africa the scope of transactions covered by the Digital Withholding Tax must be clearly identified and defined in order to provide certainty of its application to taxpayers and withholding agents.¹⁶⁹ In order to avoid classification disputes, the TFDE considers a general definition of covered transactions to be the

¹⁶⁷ OECD *Digital Economy Report*, *op cit* note 3 at 114.

¹⁶⁸ DTC Report, *op cit* note 140 at 28.

¹⁶⁹ OECD *Digital Economy Report*, *op cit* note 3 at 113.

most appropriate approach, rather than establishing a list of specific transactions.¹⁷⁰

In order to address the challenge of individuals acting as withholding agents, SARS could appoint intermediaries such as South African financial institutions to act as intermediaries. It is submitted that this would only be effective to the extent that payments are effected from South African bank accounts and would not address payments utilising digital currencies such as bitcoins. Nor would it address the situation where a non-resident is physically present in South Africa when the goods or services are rendered. In order to address this challenges, as submitted in the DTC Report, the Electronic Communications and Transactions Act could be incorporated in the Act and utilised to track enterprises which supply goods or services in South Africa, and requiring those enterprises to appoint an intermediary to act as withholding agent for all payments received from any person physically present in South Africa at the time when the goods or services are rendered.

7.3. Equalisation levy

7.3.1. OECD

In order to mitigate some of the difficulties arising from creating new profit attribution rules for purposes of the nexus based on a significant economic presence, the TFDE considered the introduction of an ‘equalisation levy’

An equalisation levy would be utilised to serve as a way to tax only non-resident enterprises with a significant economic presence, after the revenue, digital and user based factors have been considered.¹⁷¹

If the tax policy is to tax remote sales transactions, the levy could be applied to all transactions concluded remotely with in-country consumers where the supplier maintains a significant digital presence in the jurisdiction.

¹⁷⁰ OECD *Digital Economy Report*, op cit note 3 at 113.

¹⁷¹ OECD *Digital Economy Report*, op cit note 3 at 115.

7.3.2. DTC

The DTC Report was issued in 2014, based on a draft version of the OECD's Digital Economy Report. The equalisation levy was only introduced in the final report of the OECD which was released in 2015, after public comments were considered and incorporated. The DTC Report therefore did not consider the potential application of an equalisation levy in South Africa.

7.3.3. Application to the South African taxation framework

The equalisation levy could be utilised in unison with the proposal in the DTC Report to use the Electronic Communications and Transactions Act for the detection and identification of business in the digital economy.

Once enterprises conducting business in South Africa have been identified, the levy could be applied to all transactions concluded remotely with consumers physically present in South Africa where the supplier maintains a significant digital presence in the jurisdiction. The significant digital presence would be established after the revenue, digital and user based factors have been considered.

It is submitted that, through detecting and identifying enterprises conducting business in South Africa, and applying the 'significant economic presence' test, taking into account the various factors, it would assist in ensuring that the costs of implementing the system does not outweigh the benefits thereof, as it would only target entities which earn profits in excess of a revenue threshold.

8. Conclusion

The key features of the digital economy, such as mobility, the reliance on data and multi-sided business models have raised challenges to the current taxation framework. With the development of the digital economy, businesses operating within the digital economy are now able to leverage global value chains from anywhere in the world, no longer being bound to a specific geographic market. Consequently, enterprises in the digital economy no longer operate within the confines of the traditional tax principles of PE and the attribution of business profits.

It therefore became necessary to assess whether the current taxation framework remained adequate to address the tax challenges raised by the digital economy.

Various options have been considered by the OECD and the DTC, including a nexus based on a significant economic presence, amendments to the PE provisions in the OECD MTC and correspondingly in the DTAs entered into by South Africa, withholding taxes on transactions in the digital economy and equalisation levies.

After consideration of the above, it is submitted that it is clear that the current taxation framework is no capable of adequately addressing the tax challenges posed by developments in ICT in the digital economy, giving rise to various tax planning opportunities. An unequivocal response from countries across the globe is therefore necessary to prevent their tax bases being eroded through the use of tax planning opportunities in the digital economy.

It is submitted that it would however be nearly impossible for the South African government to implement certain amendments, such as the nexus based on a significant economic presence unilaterally. A multilateral approach would be the only effective approach in combatting BEPS in the digital economy.

It is submitted that certain of the proposals, such as the withholding tax on digital transactions, or the equalisation levy, could be imposed

unilaterally. Furthermore, South Africa could enact amendments to the source provisions, in order to make certain payments to non-residents from South Africa subject to tax under the source provisions. Some of the main challenges of implementing the proposals would be the actual implementation thereof.

Certain of the business models in the digital economy, including online advertisements are targeted at specific jurisdictions. Profits are often derived through specific, measurable models, such as the pay-per-click model where advertisers pay per view by a consumer.

Advertising intermediaries act as central points for advertisements in a country and could possible act as withholding agents for the withholding tax or equalisation levy. The advertising intermediaries already collect information, such as the number of clicks and specific jurisdiction from which the profits are derived, as this forms the basis of how their clients are charged. As the information is already collected, it would not be exorbitantly expensive for SARS to collect information on the revenue derived from advertisements in South Africa. SARS could therefore use this business model as a trial run for some of the proposed options.

In its report, the DTC focused narrowly on the e-commerce business model of the digital economy. Implementation of the proposals with regard to other business models, such as application stores, might be less burdensome, as there are fewer enterprises operating application stores in South Africa, making implementation more accessible and ensuring that the costs of implementing proposals would be more proportionate to the benefits obtained.

It is submitted that, if certain of the options to address the challenges raised by the digital economy are successfully implemented with regard to certain of the business models, it could be rolled out to other business models in the digital economy.

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